

27 July 2018



Mr Warwick Anderson  
General Manager, Network Finance and Reporting  
Australian Energy Regulator  
GPO Box 520  
Melbourne VIC 3001

Dear Mr Anderson

### **Review of Regulatory Tax Approach**

Ergon Energy Corporation Limited (Ergon Energy) and Energex Limited (Energex), as Distribution Network Service Providers (DNSPs) operating in Queensland, welcome the opportunity to provide comment to the Australian Energy Regulator (AER) on its Review of Regulatory Tax Approach Initial Report (Initial Report).

Together, Ergon Energy and Energex cover 1.7 million km<sup>2</sup> and supply 37,208GWh of energy to 2.1 million homes and businesses. Ergon Energy and Energex are both members of Energy Networks Australia (ENA), the national industry association that represents businesses operating Australia's electricity transmission and distribution and gas distribution networks. The ENA has prepared a response to the Initial Report and we are supportive of the positions presented in their response.

Ergon Energy and Energex agree there are variances between the regulatory tax allowance set by the AER and the actual tax paid to the Australian Tax Office (ATO). Notwithstanding, these variances should be expected given that tax paid is based on actual financial performance and in accordance with Australian taxation law and the regulatory tax allowance is a forecast benchmark allowance set in accordance with the regulatory framework. However, we do not support a move away from an incentive-based regulatory framework.

Furthermore, we agree with the key drivers of variance identified in the Initial Report and support the AER's suggestion to seek further information to explain these variances. However, we question whether it would be reasonable and appropriate to request detailed information which is not readily available or easily attributable to the DNSP which is part of a broader group structure. As noted by several other submissions to the AER's Issue's paper, to disseminate the interest expense and actual tax paid from the parent entity to the DNSP would be on an arbitrary basis. We suggest that the request for information appropriately considers information that is available or that can be readily supplied and that any cost to businesses in supplying this information is assessed against the benefit derived from supplying it. To that extent, we support supplying information to inform the assessment of an efficient benchmark, and welcome discussions with the AER in formulating the draft regulatory information notice (RIN). In particular, we suggest that for the purposes of this review, debt funding arrangements and interest costs are provided at the parent entity level.

That is, for Ergon Energy and Energex, we would supply this information at an Energy Queensland level.

Importantly, we suggest that the RIN focus on structures and practices rather than specific tax detail. Notwithstanding, we note that tax returns and specific tax information could readily be supplied for the last regulatory control period where they can be reasonably attributable to the individual DNSP. However, we note that this will involve some assumptions and/or arbitrary allocations, as prior to 2016, both Energex and Ergon Energy were still consolidated groups for tax purposes with not only unregulated activities but also wholly owned subsidiaries.

Furthermore, we note that the AER proposes issuing a final RIN in September 2018 with a Draft Determination to be issued in October 2018. It is not clear how long DNSPs will be provided to submit their RIN and given the uncertainty as to the content and detail being requested in the RIN and the assurance requirements, we are unable to comment on our ability to provide this information in the required timeframe. However, we note that this consultation period falls within the timeframe in which the Queensland DNSPs are significantly occupied in collating responses to the three annually required RINs (Annual Reporting, Economic Benchmarking and Category Analysis) which are due by the end of October 2018. As such, we expect there will be limited resources available to conduct a thorough review for this RIN. Accordingly, we suggest the AER actively consider what level of information would be sufficient to enable it to make an informed decision. We also suggest that given the extremely short timeframe, we could provide some information to the AER without the heavy assurance requirements overlaid, such as extensive audits.

Notwithstanding, it appears that the AER may require the RIN to be submitted in time for them to make their Draft Determination. Ergon Energy and Energex believe that this is an unrealistic expectation and that the AER will not have sufficient information available to them to inform a Draft Determination by October 2018. We believe that any compression of timeframes for analysis may undermine the quality of the AER's findings and any proposal to implement changes to how tax allowances are determined, which is not consistent with the national electricity objective (NEO). Specifically, we do not expect that it would be a reasonable timeframe to gather sufficient information to propose a rule change.

We note the AER's Initial Report<sup>1</sup> and Dr Martin Lally<sup>2</sup> have suggested that a change in the treatment of depreciation from straight line to diminishing value could be considered and we appreciate the reasons suggested in these papers. We note that in accordance with tax law, assets must continue to be depreciated using the same methodology for the entirety of the asset life. However, we seek clarity on whether the same principles apply for regulatory purposes. We note that such a change mid-asset life may have windfall gains or losses depending on the stage of the asset life, particularly given the long asset life of network assets.

Ergon Energy and Energex note also that the Initial Report suggests recognising new expenses (outside of the regulated operating expenditure and capital expenditure) that

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<sup>1</sup> Australian Energy Regulatory, June 2018. *Review of Regulatory Tax Approach – Initial Report*, pp38-39.

<sup>2</sup> Dr Martin Lally, June 2018. *Tax Payments Versus the AER's Allowances for Regulated Businesses*, pp25-26.

have tax implications, such as research and development and stamp duty etc. We agree with the ENA's suggestion in their submission that anything which falls outside of the regulatory framework should not be considered in the tax allowance unless it is also brought within the regulatory framework. The expenses and risks associated with these activities are borne by the DNSP and not by the customers and therefore the associated tax advantages also lie with the DNSP and it would not be appropriate for customers to benefit from this in the short term when they have not contributed to the expense. Notwithstanding, it is likely that the customers will benefit over the long run as these expenses ultimately result in efficiency gains. Moreover, we note that including these types of allowances within the regulatory framework could create perverse incentives.

Similarly, we do not support any rule change which includes accommodating the effects of tax savings from unregulated activities or businesses in the corporate structure. The businesses and activities are appropriately ring-fenced and bear the risks of their business decisions. As such, it is not appropriate that any tax advantage of these decisions should flow through to customers of the regulated business. That is, if a lower effective tax rate is driven by losses in unregulated parts of the group, it isn't economically correct for distribution customers to benefit from this. For example, if an unregulated business made a loss the carried forward tax loss is there for the business to use when they return to a profit making year. For regulated customers to benefit from this removes the purpose of the ATO allowing tax carried forward losses for the loss making entity.

With respect to gearing, Ergon Energy and Energex believe that the same estimate of benchmark efficient gearing should be used consistently throughout the regulatory process. That is, as the weighted average cost of capital and the regulatory tax allowance are both inputs in determining the revenue allowance for DNSPs, the same estimate of gearing should apply to both measures. As such, we do not support any proposal to use a different gearing ratio for the tax expense calculation to that in the rate of return building block.

Furthermore, we do not support a rule change to allow for a tax cost-pass through. This is retrospectively looking and is not consistent with an incentive based framework. Moreover, we do not support any change to the tax rate which is not consistent with what is required by tax law. That is, while the corporate tax rate is 30 per cent on taxable or net income the regulatory tax allowance should not be set at a lower rate. To change the rate for the regulatory tax allowance to one which reflects the effective tax rate of the efficient benchmark entity is similarly inconsistent with the current incentive based regulatory framework and is essentially applying a tax cost-pass through. We believe that any change to the incentive based framework should only be made where it can be demonstrated to be materially better when assessed against the NEO.

Finally, Ergon Energy and Energex would only support prospective changes to the framework. Business decisions and tax payments made in the past are as a result of the tax policy/legislation in place at that time and may no longer be seen as efficient if any changes were made retrospectively.

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact either myself on [REDACTED] or Trudy Fraser on [REDACTED].

Yours Sincerely

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